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483706—42

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 341

PACIFIC SOUTHWEST REALTY COMPANY, A CORPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 37–65) is reported in 45 B. T. A. 426. The opinion of the United States Circuit Court of Appeals (R. 213–222) is reported in 128 F. 2d 815.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 8, 1942. (R. 223.) The petition for a writ of certiorari was filed August 27,

1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether dividends paid by the taxpayer on its preferred stock are deductible as "interest paid on indebtedness" within the terms of Section 23 (b) of the Revenue Act of 1936.

2. Whether the discounts at which the taxpayer sold its preferred stock or the premiums paid in connection with the sale and redemption of its preferred stock in the taxable years were expenses that could be deducted, or amortized over the life of the stock. This depends upon whether the preferred stock represented "bonds" within the terms of Article 22 (a)–18 of Treasury Regulations 94.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title * * *

means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)–18. *Sale and purchase by corporation of its bonds.*—(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. * * *

* * * * *

ART. 23 (b)–1. *Interest.*— * * *

* * * * *

So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. (See, however, article 22 (a)–18 and section 121.)

* * *

STATEMENT

The facts, most of which were stipulated, and as found by the Board of Tax Appeals, may be summarized as follows:

In conformity with its articles of incorporation petitioner issued and sold two series of "Cumu-

lative Preferred Serial Stock." (R. 37, 42–43.) The certificates stated that they were redeemable at par, plus all unpaid, accrued, and accumulated dividends, and that the holders should have the right to enforce payment the same as on any unconditional claim or debt against the corporation. (R. 41–42.) The articles also authorized the corporation to issue bonds, though the total indebtedness of the corporation could not exceed 50 per cent of the appraised value of the property subject thereto. (R. 40–41.) First mortgage bonds in an amount substantially equivalent to the face amount of the preferred stock were issued and sold at about the same time that the stock was issued. (R. 53–54.) The stock was represented to be free from the personal property tax of the state and free from the normal federal income tax. (R. 46, 55.) The periodic payments on the stock, while cumulative, were to be made periodically only if there were profits, were denominated "dividends" and no payments were ever made except following the declaration of a dividend. (R. 58.) If dividends on the preferred stock remained delinquent more than ninety days, the voting rights vested exclusively in the preferred stockholders until all arrears in dividends were paid. (R. 42, 192.)

During the year 1936 all of petitioner's 5½ per cent preferred shares of the par value of $1,000,000 were outstanding. All of them were redeemed and retired during the year 1937. Dur-

ing the years 1936 and 1937 petitioner made payments to the holders of those securities at the rate of 5½ per cent of the par value, or $55,000 during the year 1936 and $41,250 during the year 1937. (R. 46.)

The 5½ per cent preferred stock was sold by petitioner at discounts of $3 and $5 per $100 par value, the discount aggregating $46,858. The parties stipulated that if the discount at which the securities were sold was a deductible expense, it was an expense which it was proper to amortize and deduct over the life of the securities and $1,833.26 of that discount expense was properly allocable to the year 1936 and $31,275.39 was properly allocable to the year 1937. (R. 47.)

During the year 1936 petitioner redeemed and retired all of its then outstanding 6½ per cent preferred stock for the face value thereof ($3,766,500) plus a total premium of $182,025. During the year 1937 it redeemed and retired all of its then outstanding 5½ per cent preferred stock for the face value thereof ($1,000,000) plus a total premium of $20,000. (R. 47.)

In its income tax return for the year 1936 petitioner failed to take deductions for the payments made on its securities designated 6½ per cent and 5½ per cent preferred stock, failed to take deduction for the portion of the discounts at which its securities designated 5½ per cent preferred stock were issued and sold which was allocable to the year 1936, and failed to take a

deduction for the premium paid upon the redemption of its securities designated 6½ per cent preferred stock. (R. 48.)

In redetermining petitioner's income for the year 1936 following the filing of a refund claim by the petitioner, the Commissioner did not allow any deductions for the payments made by petitioner during the year on its securities designated 6½ per cent preferred stock and 5½ per cent preferred stock, did not allow a deduction for any portion of the discount at which petitioner's securities designated 5½ per cent preferred stock were issued, and did not allow a deduction for the premium paid by petitioner upon the redemption of its securities designated 6½ per cent preferred stock. (R. 49.)

In its income tax return for the year 1937 petitioner deducted as interest paid the payments made on its securities designated 5½ per cent preferred stock in the amount of $41,250, deducted the sum of $31,275.39 as the portion of the discount at which the securities were issued and sold which was properly allocable to the year 1937, and deducted the premium paid in the amount of $20,000 upon the redemption of the securities. The Commissioner refused to allow these deductions. (R. 50.)

The Board of Tax Appeals upheld the action of the Commissioner (R. 65), and the court below, with Judge Healy concurring in a separate opinion, affirmed the judgment of the Board of Tax Appeals (R. 223).

ARGUMENT

Whether preferred stock of a corporation may be said to represent "indebtedness" within the meaning of Section 23 (b) of the Revenue Act of 1936, *supra,* so that the corporation is entitled to a deduction for interest in the amount of dividends paid, depends upon the facts of each case. *Commissioner* v. *O. P. P. Holding Corp.,* 76 F. (2d) 11, 12 (C. C. A. 2d); *Commissioner* v. *Schmoll Fils Associated,* 110 F. (2d) 611, 613 (C. C. A. 2d). Petitioner admits that this is true (Pet. 12), but asserts a conflict of decisions, contending that the reason the court below held the payments involved herein were dividends on stock, and not interest, was simply that the parties called them dividends. (Pet. 11, 14.) However, the opinion of the court below laid great weight on the facts that the dividends were payable only when declared (R. 214, 219, 220), that they were payable only out of profits (R. 217, 219), that if they were delinquent for 90 days the preferred shareholders succeeded to the exclusive voting power so long as any dividends were in arrears (R. 214), and that at the time the securities were issued the corporation declared its understanding that payments on them would be dividends and not interest (R. 219). It is clear that these facts prompted the decision below as much as, if not more than, the fact that the payments were called dividends. Petitioner's statement of the ground on which the decision below

rests is apparently based on the special concurring opinion of Judge Healy rather than on the opinion of the court.

The securities in the instant case are hybrids. Petitioner points out (Pet. 17) that under the progressively more liberal provisions of state corporation laws more of these hybrids are appearing with features both of stock and of obligations of debt, and urges that this constitutes a reason why this Court should review this case. There is, however, no reason to believe that by such review the Court can lay down rules which will be an answer to the problems of classification of all such hybrids. One may safely assume that a share of stock cannot be converted into an indebtedness for the purposes of Section 23 (b) by the addition of one feature of an indebtedness to what is otherwise a share of stock.[1] Since this is so, the classification

[1] The attempt to give controlling effect to one feature of the securities, namely the obligation to pay principal and a specified return on or before a fixed date, is not supported by the cases cited (Pet. 12). In *Commissioner* v. *J. N. Bray Co.*, 126 F. (2d) 612 (C. C. A. 5th), no declaration by the directors was required for periodic payments; in *Helvering* v. *Richmond, F. & P. R. Co.*, 90 F .(2d) 971 (C. C. A. 4th), the payments were to be made irrespective of earnings, and default entitled the holders to foreclose; in *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. (2d) 11 (C. C. A. 2d), the payments were treated by the corporation as interest on debentures and did not depend on earnings; in *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. (2d) 833 (C. C. A. 7th), the securities evidenced a loan for a year, the "dividend" being payable in any event and the transaction constituting an effort to avoid the usury law.

of one of these hybrids is a process of weighing the various features which point to its being an indebtedness against the features which point to its being stock to determine which features predominate.

The decision below, which affirmed the Board, correctly applied the principles which have been developed in this field. It weighed the features indicating stock against those indicating indebtedness and properly concluded that the former predominated. These securities entitled the holders to "dividends" from surplus when declared by the directors and entitled them to exclusive voting rights if the dividends fell into arrears. A decision that such securities were shares of stock and not obligations of debt is hardly surprising, particularly since petitioner itself, from the date of their issuance until 1937, treated them as shares of stock.

Petitioner suggests that a conflict of decisions may be anticipated because cases similar to this one are now pending in other circuits.[2] Those cases, however, all differ on their facts from this case, and in any event an assertion of conflict among the circuits is premature.

The second question in the case is whether discounts at which the taxpayer sold its preferred stock or the premiums paid in connection with the sale and redemption of its preferred stock in the

[2] None of those cases has been argued.

taxable years were expenses that could be deducted or amortized over the life of the stock. This question depends upon whether the preferred stock issued by the taxpayer constitutes "bonds" within the meaning of Article 22 (a)–18 of Treasury Regulations 94, *supra*. It is apparent that the answer to the first question in this case controls the answer to the second.

CONCLUSION

The decision of the court below is correct and there is no conflict of decisions. The case is not of general importance because it turns upon its particular facts. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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